

POLITICS, FORMALISM, AND THE ELUSIVE GOAL OF INVESTOR PROTECTION: REGULATION OF STRUCTURED INVESTMENT FUNDS IN JAPAN

HIDEKI KANDA*

1. INTRODUCTION

Investment funds offer significant opportunities to sponsors and investors. During the past few years, the industry for creatively structured investment funds has grown rapidly worldwide.¹ Such funds include buy-out and venture capital funds, mezzanine funds, index-linked funds, commodity futures funds, property funds, and various income funds. In practice, this is a complex area that involves difficult tax and other legal questions. A fund typically seeks to raise capital from investors in a large number of jurisdictions. Funds then typically make investments in a range of jurisdictions. A fund must therefore be structured so as to reconcile, as best as possible, conflicting tax treatments and other legal requirements in the relevant jurisdictions.

Organizing structured investment funds has not been popular in Japan. Restrictive regulations have been blamed for such unpopularity. Japanese regulators, aware of the necessity of addressing this criticism, have begun to move toward deregulation. Thus, in the near future, structured investment funds are expected to flourish in Japan, despite the complexity associated with deregulation.

This article examines the regulatory environment for structured investment funds in Japan. Part I describes the Japanese legal framework within which structured investment funds can be organized, operated, and marketed. Part I also explores the current Japanese Securities and Exchange Law and the recent legislation on commodity futures funds. Part II identifies some characteristics of the Japanese regulatory process, with a focus on the enforcement of current statutes and the drafting of new legislation. Part II then analyzes why those characteristics may be unique to Japan. Part II examines the process in which various special interests compete in the interpretation of current statutes and in the introduction of new legislation. Part II investigates

* Associate Professor of Law, The University of Tokyo. I thank Saul Levmore, Geoffrey Miller and Cass Sunstein for their suggestions and advice.

¹ See CLIFFORD CHANCE, *STRUCTURING BUY-OUT AND OTHER INVESTMENT FUNDS* 2 (1990).

whether this process produces a "race for the bottom." Part II also explores the formalism dominating the application of the relevant statutes in this area and the impact of such formalism. This article argues that the competition among ministries and industries tends to enhance, rather than undermine, investors' welfare in Japan. Part III briefly predicts the future of Japanese regulation in the structured investment fund area and beyond.

2. PART I: THE LEGAL FRAMEWORK

2.1. *Organizational Form and Taxation*

At the outset, a brief discussion of organizational form and tax treatment may be helpful. In general, a fund will not appeal to prospective investors, if investing through the fund results in a higher tax liability than direct investment. The fund's sponsor and advisers, therefore, attempt to structure the fund so as to obtain tax neutrality.

There are several legal forms available in Japan. For instance, a partnership (*kumiai*) has tax transparency, but usually this organizational form does not appeal to investors because it does not enjoy limited liability.² Nevertheless, this form is somewhat popular for venture capital funds in Japan. Also, some real property funds are organized as partnerships and marketed as tax shelters to a limited number of wealthy Japanese investors.

A Japanese counterpart of the limited partnership organizational form commonly used in the United States and elsewhere is a *tokumeikumiai*,³ which enjoys tax transparency. The Japanese National Tax Administration, however, adopted a rule which imposes withholding tax when the number of limited partners, or *tokumeikumiaiin*, becomes ten or more.⁴ As a result, this organizational form becomes costly, once the fund is marketed to a large number of investors.

A fund organized in the corporate form is costly. Corporations are always subject to double taxation in Japan. There is no exception to

² See MINPŌ (Civil Code), Law No. 89 of 1896 and Law No. 9 of 1898 arts. 667-88 (Japan)(describing the organizational rules on *kumiai*), reprinted in Civil Code of Japan, II Law Bull. Series Japan (EHS) FA 110-13 (1988)(English translation).

³ See SHŌHŌ (Commercial Code), Law No. 48 of 1899 arts. 535-42 (Japan)(describing the organizational rules on *tokumeikumiai*), reprinted in Commercial Code & Audit Special Exception Law of Japan, II Law Bull. Series Japan (EHS) JA 144-45 (1979)(English translation) [hereinafter SHŌHŌ].

⁴ See Income Tax Law of Japan, Law No. 33 of 1965 art. 210 (as amended)(Japan), reprinted in Income Tax Law of Japan, IV Law Bull. Series Japan (EHS) CA 293 (1989)(English translation)[hereinafter Income Tax Law]; Income Tax Ordinance, Ordinance No. 96 of 1965 arts. 288, 327 (Japan).

this precept, unlike in the United States where some corporations enjoy single-tiered taxation (e.g., investment companies and real estate investment trusts).⁵ Moreover, Japanese corporate law generally prohibits repayment of the invested monies to the shareholders, unless the corporation adopts a strict procedure for capital reduction or the corporation liquidates.⁶ Thus, investors may encounter hurdles in liquidating their investments, unless an active secondary market is developed.

From a tax perspective, a trust is attractive. A trust enjoys tax transparency.⁷ A trust agreement may provide for an investor's limited liability, although this issue is unresolved in the Japanese legal community. An investment fund employing a trust, however, is unpopular in Japan for several reasons. First, the Japanese Trust Business Law (*Shintakugyoho*)⁸ and the practice under this law have effectively limited access to the trust business. In practice, only eight Japanese banks and several foreign trust banks may engage in the trust business.⁹ A license must be obtained to serve as a trustee, and the regulator, the Ministry of Finance ("MoF"), has adopted a policy that separates the trust business industry from other financial services industries.

Second, current Japanese law is generally silent with respect to trusts that have a large number of beneficiaries, except for loan trusts and securities investment trusts, which are specifically recognized and regulated by special statutes.¹⁰ The Japanese Trust Law (*Shintakuho*)¹¹ is also silent in regard to trust certificates. With the exception of loan trusts and securities investment trusts, the issuance of

⁵ See I.R.C. §§ 851-55, 860 (1988)(United States federal tax provisions concerning single-tiered taxation for certain investment companies); *id.* at §§ 856-60 (United States federal tax provisions concerning single-tiered taxation for certain real estate investment trusts). See also Kanda & Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 245 (1991).

⁶ See SHOHŌ, *supra* note 3, arts. 375-80, 404-56, at JA 103-05, 111-26.

⁷ See Income Tax Law, *supra* note 4, art. 13, ¶ 1, at CA 34-35; Corporation Tax Law of Japan, Law No. 28 of 1947 art. 12, ¶ 1, *reprinted in* Corporation Tax Law of Japan, IV Law Bull. Series Japan (EHS) DA 14-15 (1988)(English translation).

⁸ Trust Business Law, Law No. 65 of 1922 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Trust Company, VI Law Bull. Series Japan (EHS) CA 1 (1988)(English translation).

⁹ Seven Japanese trust banks, one Japanese "ordinary" bank, and nine foreign banks have been licensed to engage in the trust business. See FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN, *THE BANKING SYSTEM IN JAPAN* 14-16 (1989).

¹⁰ See Loan Trust Law, Law No. 195 of 1952 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Trust Company, VI Law Bull. Series Japan (EHS) CB 1 (1988)(English translation); Securities Investment Trust Law, Law No. 198 of 1951 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Trust Company, VI Law Bull. Series Japan (EHS) CC 1 (1988)(English translation)[hereinafter SITL].

¹¹ Trust Law, Law No. 62 of 1922 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Trust Company, VI Law Bull. Series Japan (EHS) CD 1 (1988)(English translation).

negotiable trust certificates has not been attempted under the Japanese Trust Law.

Third, aside from loan trusts and securities investment trusts, a unit or beneficial interest in a trust fund is not a security under the Japanese Securities and Exchange Law ("SEL").¹² Consequently, there is no law to protect investors in this area. This does not mean that marketing a fund in the trust form is prohibited. In theory, one may market such a fund subject to general theories of contract law. Nevertheless, financial institutions, aware of the MoF's concern for investor protection, have not tried to sell such a product to the general public. It is important to mention that securities firms may not handle a product that is not a security under the SEL. Non-financial institutions, such as trading companies, leasing companies, and real estate companies, whose primary regulator is not the MoF, might attempt to sell such a trust-form investment fund to the general public. However, if these institutions are reporting companies under the SEL, they are subject to the MoF's jurisdiction. Thus, given the current lack of statutory protection for investors, the MoF would ambitiously discourage such an activity by these reporting non-financial institutions.

2.2. *The Framework of the Securities and Exchange Law*

The marketing of investment funds is primarily regulated by the SEL. The creation and operation of such funds are only regulated when special statutes, such as the Securities Investment Trust Law and the Law for Commodity Investment Business, are applicable. The SEL was modeled on the United States federal securities laws, specifically the Securities Act of 1933¹³ and the Securities Exchange Act of 1934.¹⁴ The SEL provides two basic sets of rules for investor protection: mandatory disclosure and anti-fraud rules.

There are several important differences between the legal systems of Japan and the United States. First, in Japan, a firm must obtain a license from the MoF to serve as a broker-dealer of securities.¹⁵ The

¹² Securities and Exchange Law, Law No. 25 of 1948 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Securities and Exchange & Foreign Securities Dealer, VI Law Bull. Series Japan (EHS) MA 1 (1987)(English translation)[hereinafter SEL]. See *infra* notes 16-17 and accompanying text for a discussion of "security" under the SEL.

¹³ Securities Act of 1933, 15 U.S.C. § 77a (1988).

¹⁴ Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988).

¹⁵ See SEL, *supra* note 12, art. 28, at MA 34. When Japanese regulations require the procurement of a license for certain activities, such a license must be obtained from the relevant *minister*, not the *ministry*. Also, various reports required under the regulations must be presented to the *minister*, not the *ministry*. Thus, a license for security business must be obtained from the *Minister* of Finance and a registration

entry barrier to this intermediary service is thus higher in Japan than in the United States, where registration, rather than licensing, is required to serve as a broker-dealer.

Second, while the notion of a security is broadly defined in the United States,¹⁶ it is quite limited in Japan. The SEL defines a security as one of the following items:

- (1) government bonds;
- (2) local government bonds;
- (3) bonds issued by a juridical person in accordance with a special law;
- (4) secured or unsecured debentures;
- (5) investment certificates issued by a juridical person established under a special law;
- (6) share certificates (including odd lot; hereinafter the same), or certificates representing subscription right to new stocks;
- (7) beneficiary certificates of securities investment trust or loan trust;
- (8) securities or certificates issued by foreign countries or foreign juridical persons, which are of the same nature as those mentioned in the preceding respective items;
- (9) other securities or certificates prescribed by Cabinet Order.¹⁷

Although the MoF is empowered to designate any new instrument as a security under item 9, it has never exercised this power. In Japanese practice, the definition of a security is limited.

Third, the distinction between a public offering (which is subject

statement for a new securities issue must be filed with the *Minister* of Finance, as well.

¹⁶ The Securities Act of 1933, 15 U.S.C. § 77b(1) (1988), defines the term security as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

¹⁷ SEL, *supra* note 12, art. 2, ¶ 1, at MA 2.

to mandatory disclosure requirements) and a private placement (which is not) differs between the two countries. Japan adopts more formalistic criteria than the United States in differentiating a public offering from a private placement. The SEL defines a public offering with two basic notions: (1) an offer is made to "many and unspecific persons"¹⁸ and (2) the offer has uniform terms.¹⁹ An interpretive release promulgated by the MoF declares that an offer is made to "many and unspecific persons" if the number of offerees is about fifty or more.²⁰ In practice, the MoF's release is "interpreted" to provide a definitive criterion of fifty or more persons.

The fourth difference between United States and Japanese securities law is that by utilizing the notion of a security, the Japanese SEL links its investor protection rules to Article 65 of the SEL (a rule similar to the United States' Glass-Steagall Act of 1933),²¹ which essentially prohibits banks from engaging in the securities business.²² This regulatory structure is known as the "one-set structure" in Japan and is the key to understanding past and future developments in the regulation of new financial instruments in Japan. If a financial product is a security, as defined by the SEL, investors enjoy the protection of the SEL, while banks are prohibited from handling such a product. Article 43 of the SEL prohibits securities firms from dealing with a product other than a security unless they obtain special permission from the MoF.²³ If a product is not a security, banks may handle it, while securities firms may not, and investors receive no legal protection from the SEL.

The MoF, in response to the long battle between the banking and

¹⁸ *Id.* art. 2, ¶ 3, at MA 3.

¹⁹ *Id.*

²⁰ RELEASE ON HANDLING DISCLOSURE OF THE FIRM'S CONTENTS, MINISTRY OF FINANCE RELEASE NO. 2272 §§ 2-1, 2-2-2 (Sept. 6, 1971)(as amended)[hereinafter RELEASE ON HANDLING DISCLOSURE]. In practice, this interpretative release is relied upon when interpreting the notion of "many and unspecific persons" in other statutes.

²¹ Glass-Steagall Act, 12 U.S.C. § 227 (1988).

²² SEL art. 65, ¶ 1 provides:

No bank, trust company or such other financial institutions as prescribed by Cabinet Order shall engage in any of the acts enumerated in each item of Article 2 paragraph 8: Provided that, this shall not apply in such cases wherein a bank buys and sells securities upon a written order of and in the account of a customer, or a bank, a trust company or other financial institution as may be prescribed by Cabinet Order buys and sells securities for the investment purpose or in the account of a trustor based on trust contract in accordance with the provisions of other laws.

SEL, *supra* note 12, art. 65, ¶ 1, at MA 51. Article 65, ¶ 2 of the SEL permits banks and other certain financial institutions to engage in securities business with government securities and futures and options related to such securities. *Id.* art. 65, ¶ 2, at MA 51.

²³ *Id.* art. 43, at MA 40-41.

securities industries, placed priority on the issue of which industry handles each new product over the issue of investor protection. For example, the MoF adopted a policy that permits both banks and securities firms to handle commercial paper.²⁴ Securities firms received special permission to handle commercial paper as an intermediary service under Article 43 of the SEL.²⁵ Meanwhile, the banking industry successfully persuaded the MoF to exclude securities firms from intermediary services for residential mortgage trusts and securitized bank loans. To obtain these results, the MoF did not designate these transactions as securities; the MoF treated them as non-securities, which banks may deal with under the SEL.

The above approach resulted in the absence of legal protection for investors. To remedy this situation, the MoF took two actions. First, it had special legislation enacted to protect investors. For example, *teitoshoken*, or mortgage deed, is in this category.²⁶ Second, by rule or administrative guidance, the MoF mandated that banks (and securities firms with respect to commercial paper) not sell these products with a unit value of less than one hundred million yen. The purpose of this limitation was to prevent the sale of such products to the general public, which is in need of the protection provided by the securities law. Commercial paper and residential mortgage trusts are in this category. Certificates of deposit are also in this category, but the "minimum unit rule" has been liberalized for this instrument.²⁷

The SEL's narrow definition of "security" has been strongly criticized.²⁸ As previously noted, the MoF took two actions in regard to non-securities to protect investors. New legislation, however, has enormous costs; for example, hundreds of new statutes must be passed, and

²⁴ See Litt, Macey, Miller & Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369 (1990)(a detailed analysis of the introduction of commercial paper in both Japan and the United States) [hereinafter *Politics*].

²⁵ SEL, *supra* note 12, art. 43, at MA 40-41.

²⁶ See Law for Regulating Business on Mortgage Deed, Law No. 114 of 1987 (Japan).

²⁷ The minimum unit amount is 50 million yen. The assumption is that issuers of certificates of deposit, or banks, are subject to stricter regulation than issuers of other instruments, such as commercial paper and residential mortgage trust certificates. See RELEASE ON HANDLING CERTIFICATES OF DEPOSIT, MINISTRY OF FINANCE RELEASE NO. 650 (May 30, 1979)(this release is a package of twelve releases). This picture is incomplete without mentioning the battles and interactions between the Banking and Securities Bureaus within the MoF. See generally Aoki, *The Japanese Bureaucracy in Economic Administration: A Rational Regulator or Pluralist Agent?*, in GOVERNMENT POLICY TOWARD INDUSTRY IN THE UNITED STATES AND JAPAN 265 (J. Shoven ed. 1988)(an interesting analysis of the Japanese bureaucracy).

²⁸ See, e.g., Takeuchi, *Shokentorihikihojono Yukashoken (Securities under the Securities and Exchange Law)*, in SHOKENTORIHAKIHO TAIKEI 21 (1986)(in Japanese).

no new financial product may be sold until corresponding legislation is enacted. The "minimum unit rule" disqualifies new financial products from potential sale to small investors, thereby hindering the development of secondary markets and raising initial financing costs. In short, many people who deal with Japanese "non-security securities" are waiting for fundamental reform of the SEL. In this context, the Fundamental Research Committee of the Securities and Exchange Council at the Securities Bureau of the MoF has been considering a complete overhaul of the SEL since 1988.²⁹

It is difficult to predict the modifications that the current SEL will undergo. Perhaps the notion of a security should be expanded to cover any investment and the rules for investor protection should be separated from Article 65. The Fundamental Research Committee is unlikely to accept this position because of the political differences between the many ministries and industries. I predict that the Japanese definition of a security will be extended to some extent.

2.3. Regulation of Securities Investment Trusts

A securities investment trust is regulated by the Securities Investment Trust Law ("SITL").³⁰ The sponsor, labelled as the settlor of the trust in Japan for regulatory reasons, must obtain a license from the MoF and serve as a manager of the trust fund. The MoF also must approve the trust deed. Because of this substantive regulation, a unit of the trust fund is an "exempted security" under the SEL to which the disclosure requirements of the SEL do not apply.³¹ This type of fund may invest primarily in securities, as defined by the SEL. SITL explicitly prohibits any other form of a trust for pooled investment in securities, if the fund is marketed to "many and unspecific persons."³² For the past few years, trust banks have offered a "fund trust" to their corporate customers. In the fund trust arrangement, customers transfer money to the trust bank, and the bank, as trustee, invests in securities. The trust bank industry maintains that the fund trust does not violate the SITL prohibition, because the fund's structure does not allow units to be marketed to "many and unspecific persons."³³

²⁹ See SECURITIES & EXCH. COUNCIL, HOW BASIC SYSTEM REGARDING CAPITAL MARKET OUGHT TO BE REFORMED (June 19, 1991).

³⁰ SITL, *supra* note 10.

³¹ SEL, *supra* note 12, art. 2, ¶ 1(7), at MA 2; *id.* art. 3, at MA 6.

³² SITL, *supra* note 10, art. 3, at CC 2; see SEL, *supra* note 12, art. 2, ¶ 3, at MA 3.

³³ SEL, *supra* note 12, art. 2, ¶ 3, at MA 3.

2.4. Other Statutes

Two other statutes are worth noting briefly. First, the Law for Prohibition of Acceptance of Money Deposit and Related Activities (*Shusshiho*)³⁴ generally prohibits anyone from receiving monies with a promise of subsequent repayment, in a fixed amount, from “many and unspecific persons.”³⁵

Second, Japanese criminal law prohibits gaming or gambling.³⁶ If investors promise to buy a unit of a highly speculative fund, they, as well as the fund’s sponsors, may violate this statute, unless there is another statute, such as one for certain futures and options, explicitly permitting such a high-risk investment.

2.5. Funds Organized Outside Japan

When one seeks to create an investment fund outside Japan, a critical question is how one can market it to Japanese investors under Japanese law. If one wants to sell off-shore fund units to investors in Japan, the answer largely depends upon whether such units are “securities,” as defined by the SEL.

If a unit is a security, a license from the MoF is required in order to sell that unit as a broker-dealer in Japan. In other words, only securities firms can sell “securities.” Further, Article 65 of the SEL prohibits banks from intermediary services.³⁷ When a foreign institution wants to serve as a broker-dealer of a security, it must set up a separate vehicle or a branch in Japan. Each branch must be licensed by the MoF pursuant to the Law Concerning Foreign Securities Dealer.³⁸ A banking institution may create a securities branch, if it organizes an affiliate outside Japan. The bank’s ownership of the affiliate may not exceed fifty percent, and the affiliate must enter Japan with a branch. A foreign firm that lacks a broker-dealer license may execute transactions with Japanese investors only if: (1) no solicitation is involved and (2) the transactions are with licensed broker-dealers or with other “ex-

³⁴ Law for Prohibition of Acceptance of Money Deposit and Related Activities, Law No. 195 of 1954 (Japan), *reprinted in* Japanese Laws Relating to Trust Company, VI Law Bull. Series Japan (EHS) EN 1 (1988)(English translation).

³⁵ SEL, *supra* note 12, art. 2, ¶ 3, at MA 3.

³⁶ See KEIHO (Penal Code), Law No. 45 of 1907 ch. 23, arts. 185-86 (Japan), *reprinted in* Penal Code of Japan, II Law Bull. Series Japan (EHS) PA 37 (1988)(English translation).

³⁷ SEL, *supra* note 12, art. 65, at MA 51.

³⁸ Law Concerning Foreign Securities Dealer, Law No. 5 of 1971 art. 3 (as amended)(Japan), *reprinted in* Japanese Laws Relating to Securities and Exchange & Foreign Securities Dealer, VI Law Bull. Series Japan (EHS) MC 3 (1987)(English translation).

empted" entities, as specified under the Law Concerning Foreign Securities Dealer. Finally, the mandatory disclosure and anti-fraud rules of the SEL apply. For instance, if one sells units to "many and unspecified persons," the issuer of the units must file a registration statement with the MoF.³⁹

If a unit is not a security, anyone may sell it in Japan. Securities firms, however, must obtain special permission from the MoF in order to sell such units.⁴⁰ Those who engage in intermediary services may also be asked to obey the "minimum unit rule," particularly when their primary regulator is the MoF.⁴¹ It is unclear what penalties are involved if this rule is violated.

An off-shore investment fund unit is a security, if it satisfies the requirement of Article 2, paragraph 1(8) of the SEL.⁴² For most investment funds today, there are three "routes" by which a unit is deemed to be a security. First, it may have the characteristics of a beneficial certificate of a securities investment trust. This is relatively rare because a securities investment trust is narrowly defined. A securities investment trust must be in the trust form and it must invest in securities. Second, such a unit may have the characteristics of a corporate debt security. Finally, the unit may have the characteristics of corporate stock.

Legal form, rather than economic substance, prevails in Japan. If, therefore, an off-shore fund is organized as a corporation, the units of such a fund are normally characterized as debt securities or as shares. These units are treated as securities in Japan. If the organizational form of the fund is a trust or a limited partnership, the unit is not a security. If one wants to sell such a non-security through securities firms in Japan, one must obtain special permission from the MoF, pursuant to Article 43 of the SEL.⁴³ Traditionally, the MoF's decision to issue such permits has been a function of the competition between the banking and securities industries. Recently, however, the MoF seems more willing to issue such permits, in part because the MoF is actively liberalizing the wall between the two industries. For example, in the Fall of 1990, a securitized product of credit card receivables, which was organized in the United States in the trust form, was brought into Japan. Several foreign and Japanese securities firms successfully obtained

³⁹ See SEL, *supra* note 12, art. 2, ¶ 3, at MA 3.

⁴⁰ See *id.* art. 43, at MA 40-41.

⁴¹ See *supra* notes 26-27 and accompanying text for a discussion of the "minimum unit rule."

⁴² SEL, *supra* note 12, art. 2, ¶ 1(8), at MA 2.

⁴³ *Id.* art. 43, at MA 40-41.

special permission from the MoF to sell this product in Japan.

Two additional observations are worthwhile. First, the regulatory environment for futures and options differs from that described above. For futures and options, a product's classification as a security under the SEL is unimportant. The SEL applies to securities-related futures and options through a route other than Article 2, paragraph 1.⁴⁴ Two other statutes also regulate futures and options. One is the Financial Futures Trading Law,⁴⁵ which regulates currency and interest futures and options. The other is the Commodity Exchange Law,⁴⁶ which regulates commodity futures and options.

The existence of three separate statutes regulating futures and options in Japan simply reflects the divisions among the regulators⁴⁷ and the respective industries that seek "protection" by the regulation. At any rate, it is important to note that rules on futures and options are different from the rules on "physicals." For instance, foreign firms which do not have a broker-dealer license are not permitted to execute futures or options transactions with Japanese investors, even if no solicitation is involved.

Second, anti-gambling laws also pose a concern with respect to the marketing of off-shore funds to Japanese investors.

2.6. *Legislation on Commodity Futures Funds*

In May of 1991, new legislation was introduced in Japan to regulate commodity futures funds, which are known as commodity pools in the United States. This law, the Law for Commodity Investment Business,⁴⁸ has an interesting history. In 1990, when trading companies and leasing companies found off-shore commodity futures funds to be attractive for marketing to Japanese investors, these companies success-

⁴⁴ See *id.* art. 2, ¶¶ 8, 13, at MA 3-4. This complicated structure was adopted to allow banks and securities firms to engage in intermediary business. See *supra* notes 24-27 and accompanying text.

⁴⁵ Financial Futures Trading Law, Law No. 77 of 1988 (Japan).

⁴⁶ Commodity Exchange Law of Japan, Law No. 239 of 1950 (as amended), *reprinted in* Commodity Exchange Law of Japan, VI Law Bull. Series Japan (EHS) MM 1 (1986)(English translation).

⁴⁷ In Japan, most bills are submitted to the Diet by the Cabinet. For each bill, there is a "sponsoring" ministry or bureau of a ministry, which drafts the statute and then, once the legislation is passed, administers the statute. Sometimes two ministries jointly sponsor a bill. The SEL is "governed" by the Securities Bureau of the MoF. The Financial Futures Trading Law is sponsored by the Banking Bureau of the MoF. The Commodity Exchange Law is jointly governed by the Ministry of Agriculture, Forestry and Fisheries ("MAFF") and the Ministry of International Trade and Industry ("MITI"). The MAFF has jurisdiction over agricultural commodities and the MITI over non-agricultural ones.

⁴⁸ Law for Commodity Investment Business, Law No. 66 of 1991 (Japan).

fully persuaded the Ministry of International Trade and Industry ("MITI") to launch a project for special legislation.⁴⁹ The MITI first contemplated legislation with the same statutory structure as the United States' Commodity Exchange Act,⁵⁰ which regulates the commodity pool operator, the sponsor in this field. However, the draft prepared by the MITI encountered strong opposition from the MoF.⁵¹

The MoF rejected the statutory approach directly regulating commodity pool operators on the grounds that the business of such operators consists of financial services. Such a business is similar to the functions of sponsoring or settlor companies of securities investment trusts, except in this instance the fund invests in commodity futures instead of securities. The MoF also noted that it would be expanding the definition of a "security" under the SEL.⁵² The MoF further stated that units of investment funds, including commodity futures funds, should be subject to the same regulations in order to enhance investor protection. The MoF argued that economic substance should control and that such funds should be regulated by the SEL, under the MoF's jurisdiction.⁵³ Moreover, the MoF contended that when financial institutions participate in the commodity futures fund business, either as a sponsor or as a seller of the units, they should be subject to their home regulator, that is, the MoF.⁵⁴

This battle between the MITI and the MoF resulted in the MITI's abandonment of the legislation that would directly regulate the sponsor of commodity futures funds. In its place, a compromise was developed. The compromise legislation was jointly sponsored by the MAFF, the MITI, and the MoF. Consequently, its regulatory structure is highly complex.⁵⁵

In creating this legislation, an initial practical assumption was made by the drafters. This assumption stipulated that there are two legal types of commodity futures funds: the contract type and the trust type. The former is typically organized in the limited partnership

⁴⁹ Since certain agricultural commodities belong to the MAFF's jurisdiction, it is accurate to state that the MITI and the MAFF attempted to introduce new legislation. In practice, however, the MAFF is unimportant in the commodity futures fund area and it did not play an important role in the enactment of the new legislation. The MAFF will not be elaborated upon in this article.

⁵⁰ Commodity Exchange Act, 7 U.S.C. § 1 (1988).

⁵¹ See Note, *Shohin Fund Hoan Kimaru (A Bill for Commodity Funds Completed)*, 68 SHIHONSHIJO 46 (1991)(in Japanese) [hereinafter Note].

⁵² See SECURITIES & EXCH. COUNCIL, *supra* note 29.

⁵³ See Note, *supra* note 51.

⁵⁴ See *id.*

⁵⁵ Until a detailed set of ordinances and rules is promulgated by the ministries, the exact contents of the compromise legislation will remain unknown. Such promulgation has not occurred at the time of this writing.

form.⁵⁶ The latter is generally structured in the trust form.⁵⁷ On this assumption, the new legislation was structured to impose licensing requirements—and other supervisory and “conduct-of-business” regulations—on the seller of the fund and the adviser for the fund. The scope of the seller’s permissible activities is broadly defined so as to include fund organizing and sponsoring; however, such activities are permissible only for the contract type fund. For the trust type fund, if a trading company or leasing company, for instance, obtains an adviser-license and employs a trust bank as trustee for the fund, the trading company or leasing company can manage the fund by entering into a management contract that requires the trustee to follow the adviser’s investment directions. For both fund types, if a trading company or leasing company obtains a seller-license, it can market the fund under the supervisory and “conduct-of-business” regulations of the Law for Commodity Investment Business and the rules to be promulgated by the MITI.⁵⁸ The units of the fund, however, are not “exempted securities” under the current SEL. The SEL is triggered, if the units fall within the SEL’s definition of “security.”⁵⁹

Financial institutions, such as banks, trust banks, securities firms and sponsoring companies of securities investment trusts, are exempt from the applicable licensing requirements under the Law for Commodity Investment Business. Thus, these institutions may serve as sellers or advisers without a license. This exemption from the licensing requirements for financial institutions stems from the fact that these institutions are subject to their “home” regulation of the MoF. However, the MoF is expected to promulgate a detailed set of supervisory rules and “conduct-of-business” regulations, under the Law for Commodity Investment Business, to regulate the activities of these exempt financial institutions.

3. PART II: CHARACTERISTICS OF JAPANESE REGULATION

3.1. *The Process of Legislation and Administrative Rulemaking*

The Japanese legal environment for structured investment funds, described in Part I, suggests several characteristics of the legislative and

⁵⁶ See Hara, *Shohin Fund no Genjyo to “Shohin Toshi nikakaru Jigyo no Kisei nikansuru Horitsu” no Gaiyo (Present State of Commodity Funds and the Overview of the Law for Commodity Investment Business)*, 1288 KINYUHO MUJYO 22 (1991) (in Japanese). A corporate type fund did not receive much attention because of its unpopularity due to tax disadvantages.

⁵⁷ See *id.*

⁵⁸ See *id.*

⁵⁹ See SEL, *supra* note 12, art. 2, ¶ 1, at MA 2.

administrative rulemaking processes of Japan. While it may be universally accepted that various special interest groups compete in most legislative and administrative rulemaking processes, the entire Japanese political environment in which private interest groups and regulators interact might be viewed as unique to Japan. As shown earlier, the treatment of "non-security securities" under the SEL might look familiar at first glance; the banking and securities industries competed and the MoF served as a mediator. The battle resulted in the classification of new financial instruments as "non-security securities" under the SEL, which enabled the banking industry to enter the market. To insure investor protection, the MoF actively intervened either by making special legislation or by promulgating new rules or administrative guidance. The MoF's action can be viewed as a function of the battle between special interest groups. The promulgation of administrative guidelines that create the "minimum unit rule" for certain public offerings of "non-security securities" represents a victory for the securities industry to the extent that the rule is applied and effectively enforced. Public investors suffer to the extent that "non-security securities" with small investment units are not available in the marketplace.

An important customary "rule" exists in Japan. That is, the non-existence of an "explicit" legal rule endorsing a certain activity under explicit regulatory conditions is understood to mean that such activity is prohibited in Japan. When no explicit rule exists as to whether a particular new instrument—such as a negotiable certificate representing the beneficial interest of a trust (other than a loan trust or securities investment trust)—is treated as a security under the SEL or if the rules are unclear, institutions do not invent and market such instruments. Put differently, until a consensus is reached on a financial device, followed by a lengthy process for establishing an explicit rule or administrative guideline, virtually no one creates or markets such a financial instrument.

In the case of commodity futures funds, it is easy to see why the MITI sought to introduce new legislation to "deregulate" the area. One common explanation is that the introduction of new means of investment in commodity futures enhances public investors' welfare. Another explanation for the MITI's conduct is found by examining the interests of trading companies and leasing companies. These companies did not want to violate the "no-rule-means-prohibition" rule. Instead, these companies persuaded their regulator, the MITI, to "regulate" them. The real estate industry did not join this chorus, simply because its regulator is the Ministry of Construction ("MoC") and not the MITI. The MITI's plan encountered strong opposition from the MoF,

which apparently received support from the securities and banking industries. The result was a compromise.

The originally proposed statutory structure, under which pool operators would be subject to regulation solely within the jurisdiction of the MITI (and not the MoF), was abandoned. But as a practical matter under the new legislation, trading companies and leasing companies could operate commodity futures funds by obtaining a seller-license from the MITI. Financial institutions could operate such funds without a license from the MITI, but they would be subject to any additional requirements that the MoF promulgates. Beyond the area regulated by the new legislation, which is narrower in its scope of application than the originally proposed draft, the "no-rule-means-prohibition" rule controls. Until the MoC introduces new legislation, the real estate industry is left unregulated and subject to the "no-rule-means-prohibition" rule during the transitional period. The MoC is expected to draft new legislation for property investment funds in the near future. A battle with the MoF appears likely.

It is important to mention that there is no litigation in this area in Japan. All relevant parties participate in the administrative rulemaking and legislative processes. Once an accord is reached, it is unlikely that such an accord will be challenged before a court. When a dispute is resolved by introducing new legislation, it may be difficult and costly to judicially attack such legislation. Likewise, judicial challenges against administrative rulemaking are also rare. However, the lack of judicial challenges in this area may initially seem puzzling, but in fact, this circumstance can be readily explained.

The "special interest theory" of legislation is well-established in the United States.⁶⁰ For instance, it has been argued that the United States' Glass-Steagall Act,⁶¹ which separates the banking and securities businesses, stems from the special interest of the investment banking industry, rather than from the public interest.⁶² However, the exact effect competing private interests have on the final product of legislation has not been studied in depth.⁶³ It might be difficult to prove that when legislation is the product of a battle among multiple competing private

⁶⁰ See generally Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. ECON. 211 (1976); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), revised and reprinted in G. STIGLER, *THE CITIZEN AND THE STATE: ESSAYS IN REGULATION* (1975).

⁶¹ Glass-Steagall Act, 12 U.S.C. § 227 (1988).

⁶² See Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1 (1984).

⁶³ See, e.g., Rubin, *Law and Legislation in the Administrative State*, 89 COLUM. L. REV. 369, 369-70 (1989).

interests, a more beneficial result is attained for the general public. The Japanese legislation on commodity future funds, however, protects investors to the extent that it is coupled with the Japanese "no-rule-means-prohibition" rule under the SEL, though this is not the best solution.

In the United States over the past few decades, federal agencies have shifted the bulk of their activities "from case-by-case adjudication to general rulemaking proceedings in order to develop administrative policy."⁶⁴ While it is well-known in the United States that administrative rulemaking is more vulnerable to judicial challenge than administrative adjudication,⁶⁵ the reverse is true in Japan. Indeed, in Japan, administrative adjudication has sometimes been litigated,⁶⁶ but no one has challenged a rule that was created through a lengthy decision-making process in which all relevant parties participated.

The complicated and time-consuming decision-making process that accompanies legislation and administrative rulemaking in Japan may be viewed as a "monitoring" system of the conduct or activities covered by the legislation or administrative rulemaking. Parties with multiple interests who participate in the process serve as *ex ante* monitors, while parties who litigate legislation or administrative rules serve as *ex post* monitors. Since *ex ante* monitoring exists, it is not surprising that there are virtually no judicial challenges to legislation or administrative rules in Japan.

It is difficult to determine, as a general matter, whether *ex post* monitoring is more costly than *ex ante* monitoring.⁶⁷ However, *ex ante* monitoring has certain advantages. First, while competing ministries and private industries seek to further their own interests, a compromise will often be reached, when a norm enhancing public interest is developed. Second, *ex ante* negotiation may mean that the cost of uncertainty is not borne by investors. Thus, in Japan, investors can choose from stable alternatives. In contrast, a system that does not have *ex ante* monitoring offers more choice and more innovation, but at a cost.

One might ask whether there is anyone who directly represents public investors in the Japanese legislative and administrative rulemak-

⁶⁴ Stewart, *Vermont Yankee and the Evolution of Administrative Procedure*, 91 HARV. L. REV. 1805, 1811 (1978). See generally, Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921 (1965).

⁶⁵ See Stewart, *supra* note 64, at 1810.

⁶⁶ For instance, administrative adjudication of the Fair Trade Commission has often been litigated in Japan.

⁶⁷ See generally *Politics*, *supra* note 24 (presenting a theory on the preclearance-postclearance distinction in regard to the commercial paper market).

ing processes. Japanese custom provides that the decision-making process at the ministry level is accompanied by a lengthy discussion at an advisory council (*shingikai*).⁶⁸ The advisory council is organized at the ministry and some of its participants are selected as representatives of public investors. Although the primary purpose of the advisory council is to accommodate the competing interests among the relevant private industries, the interests of public investors are considered, at least to some extent, through certain advisory council representatives.

Viewed in this light, the “no-rule-means-prohibition” rule makes sense in Japan. Conduct that is subject to this rule, such as marketing negotiable trust certificates, has not received the scrutiny of the ex ante monitoring process. Thus, if one pursues such conduct, it is likely to be monitored ex post, perhaps by litigation or by some other social sanction. Ex post monitoring may be undesirable in Japan.

The dominance of administrative rulemaking over administrative adjudication also makes sense in Japan. Less ex ante monitoring exists in an administrative adjudication, because the number of participants in the adjudication process is limited. Further, ex post litigation might be costly. Thus, the Japanese favor general administrative rulemaking, when it is coupled with ex ante monitoring.

3.2. *Formalism in Administrative Rulemaking*

The MoF’s rules and guidelines under the SEL are formal. The legal norm for a particular activity or conduct consists of complex formal rules. As was described in Part I, in the context of differentiating between a public offering and a private placement, the term “many and unspecific persons” is interpreted to be fifty or more persons, irrespective of whether the offerees can “fend for themselves.”⁶⁹ The “minimum unit rule” for certain “non-security securities” is simply one hundred million yen. Under the SEL, the determination as to whether units of an investment fund are treated as securities depends on the legal form of the fund. If the fund is organized as a corporation, the units are securities; however, if the fund is organized in the trust form, the units are not securities. Emphasizing legal form over economic substance often creates loopholes. The Japanese formalism in administrative rulemaking appears bewildering.

Since an administrative branch of government is often better equipped to gather and evaluate information in the development and implementation of a policy as compared to a judicial branch of govern-

⁶⁸ See *id.* at 409 n.138.

⁶⁹ See RELEASE ON HANDLING DISCLOSURE, *supra* note 20, at §§ 2-1, 2-2-2.

ment, one might expect that an administrative branch prefers to enforce substantive rules instead of formalistic rules. In Japan, the reverse is true.

In the United States, extensive studies have been conducted that analyze how an administrative branch or administrative agency of the government chooses among multiple means in developing and implementing a policy goal.⁷⁰ However, studies have not focused on whether these groups prefer to enforce formalistic rules. Japan's tendency to favor formalistic rules may be better understood by focusing on the rulemaking process in Japan.

First, at the political level, a legal norm for a particular activity or conduct consists of complex formalistic rules. These rules represent the compromise that was reached during the rulemaking process. Each formalistic rule is easy to observe. The participants in the rulemaking process may clearly indicate each "point" in order to specify the concessions made to each participant.

Second, a legal norm with multiple formalistic rules may withstand a subsequent judicial challenge better than a substantive norm would withstand such a challenge. Judges are better equipped to make a substantive inquiry as it pertains to a particular case. Further, judges may not want to involve themselves in the hard task of dealing with a complex mixture of formalistic rules. This in turn might discourage litigation.

Third, at the theoretical level, formalistic rules might better fit ex ante monitoring than substantive rules. If the legal norms or constituent rules are of a substantive nature, future activities or conduct might be difficult to identify ex ante. Consequently, ex ante monitoring may become extremely difficult and ineffective. Formalistic rules help ex ante monitors to identify future activities and conduct during the rulemaking process, which facilitates the development of a final legal norm.

4. PART III: THE FUTURE OF JAPANESE REGULATION

Capital markets are becoming international. As such, it is no surprise that institutions —mostly trading companies and leasing companies— have tried to market structured investment funds that are organized and managed outside Japan to Japanese investors. Indeed, one of the purposes of the new legislation on commodity futures funds was to

⁷⁰ See Shapiro, *supra* note 64. See also Scholz, *Cooperative Regulatory Enforcement and the Politics of Administrative Effectiveness*, 85 AM. POL. SCI. REV. 115 (1991).

“deregulate” the marketing activities associated with such funds by lifting the “no-rule-means-prohibition” rule. Therefore, “deregulation” was achieved through regulation. As the market for structured investment funds becomes international, it is possible that the traditional regulatory environment in Japan, which, as analyzed in Part I, appears sensible in isolation, may gradually change. These changes may arise in response to differences in the regulatory environments of various countries. Such differences might prevent worldwide investment fund activities and place a country that has a strict or unique regulatory environment in an unfavorable competitive position. The increased need for regulatory cooperation in the international financial services area, such as in the enforcement of insider trading regulations, may influence the Japanese regulators toward a more universal standard in administering and enforcing their policies in structured investment funds. In fact, the MoF is considering a somewhat comprehensive overhaul of the SITL in order to cope with the international trends of deregulation and harmonization.⁷¹

Thus, the regulatory environment in Japan may change in the future as a result of foreign competitive pressures. Over time, Japan’s lengthy legislative and administrative rulemaking processes may unfavorably impact Japan’s competitive edge. Japan’s political and economic responses to rapidly changing global environments in the financial services area may lag behind competitors. If Japan seeks to move with greater speed in this area, the analysis advanced in Part II suggests that the *ex ante* monitoring mechanism associated with the legislative and administrative rulemaking processes will gradually disappear. *Ex post* monitoring mechanisms will appear as a substitute for *ex ante* mechanisms. If such a shift does not rapidly occur, it might reinforce the argument that *ex ante* monitoring mechanisms are efficient.

5. CONCLUSION

This article has examined the Japanese regulatory environment for structured investment funds. The restrictive nature of this environment, as evidenced by the provisions of the SEL and the new legislation for commodity futures funds, reflects the underlying political landscape in Japan, that is, the competition among ministries and private industries. It is difficult to evaluate whether public investors are victimized in this political environment. It is sensible to have the ministries and private industries compete for their best interests, rather than allowing

⁷¹ See SECURITIES & EXCH. COUNCIL, *supra* note 29, at 6.

public interest to control the political environment. Moreover, since this process can be viewed as an *ex ante* monitoring mechanism through legislation and administrative rulemaking, the argument can be made that this regulatory environment tends to enhance, rather than diminish, investors' welfare. The internationalization of the capital markets will probably affect this distinguishing characteristic of Japanese regulation. Yet, from a theoretical perspective, future changes in the Japanese regulatory environment might not be a surprise, if one subscribes to the notion of *ex ante* monitoring mechanisms embedded in the legislative and administrative rulemaking processes. To the extent that the *ex ante* monitoring mechanisms may be phased out, new *ex post* monitoring mechanisms may well emerge in Japan.